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IN THE

Supreme Court of the United States

October Term, 1956.

No. 167

HENRY A. MASTELLER, JAMES J. McGINNIS, ALBERT J. BADER, EARL D. STICKLEN, JOHN A. DRISCOLL, JAMES F. McGOWEN, THOMAS L. McNEE and GENERAL INDUSTRIES, INC.,

Petitioners,

v.

WALTER M. GRAFTON.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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INDEX.

	Page
Opinions Below	1
Jurisdiction	2
Questions Presented for Review	2
Constitutional Provisions and Statutes Which the Case Involves	2
Statement of the Case	3
Reasons for Allowance of the Writ	4
Conclusion	7
Appendix A (Opinion of the Court Below)	9

TABLE OF CASES CITED.

	Page
Gearhart v. Standard Steel Car Company, 223 Pa. 385, 72 Atl. 699 (1909)	5

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Henry A. Masteller, James J. McGinnis, Albert J. Bader, Earl D. Sticklen, John A. Driscoll, James F. McGowen, Thomas L. McNee and General Industries, Inc., your petitioners, pray that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Third Circuit entered in the above-entitled case on April 25, 1956.

OPINIONS BELOW.

Opinion of District Court of the United States for the Eastern District of Pennsylvania dated July 18, 1955 not reported.

Final Decree of District Court, dated September 20, 1955 not reported.

Opinion of Court of Appeals for the Third Circuit, dated April 25, 1956 not reported.

JURISDICTION.

1. The Decree of the United States District Court for the Eastern District of Pennsylvania was entered on September 20, 1955. The Judgment of the United States Court of Appeals for the Third Circuit, affirming the decree of the District Court, was entered on April 25, 1956.

2. The Jurisdiction of this Court is invoked under the provisions of 28 USC Sec. 1254 (1).

QUESTIONS PRESENTED FOR REVIEW.

Can a Federal District Court order a Pennsylvania Corporation to violate the public policy, Constitution and Statutes of the Commonwealth of Pennsylvania by ordering such Coporation to "forthwith issue and deliver" to the Plaintiff shares of stock for which Plaintiff gave a note which he has never paid or offered to pay.

THE CONSTITUTIONAL PROVISIONS AND STATUTES WHICH THE CASE INVOLVES.

Article 16, Section 7 of the Constitution of Pennsylvania:

> "No corporation shall issue stocks or bonds except for money, labor done, or money or property actually received; and all fictitious increase of stock or indebtedness shall be void. The stock and indebtedness of corporations shall not be increased except in pursuance of general law, nor without the consent of the persons holding the larger amount in value of the stock, first obtained at a meeting to be held after sixty days notice given in pursuance of law."

Section 603 of the Pennsylvania Corporation Code, 15 P. S. 2852-603, 1933, May 5, P. L. 364, Article 6, Section 603:

> "A. Shares of a business corporation shall not be issued except for money, labor done, or money or prop-

erty actually received. Subscriptions for shares having a par value shall be made payable with money to an amount not less than the aggregate par value of the shares subscribed for or with consideration other than money, the fair value of which to the corporation is not less than the aggregate par value of the shares subscribed for. * * * (1933, May 5, P. L. 364, Art. VI, § 603.)

Section 604 of the Corporation Code:

"* * * No note or obligation given by a shareholder, whether secured by pledge or otherwise, shall be considered as payment, in whole or in part, of any shares of a business corporation." (1933, May 5, P. L. 364, art. VI, § 604.)

STATEMENT OF THE CASE.

In 1946 Respondent, Walter M. Grafton and three of the Petitioners formed the Petitioner-Corporation. At the organizational meeting of the Corporation, the Respondent was elected President and as President, signed four stock certificates, each representing fifty shares of stock in the Corporation of a par value of fifty dollars each. Two of the incorporators paid cash to the Corporation and received stock certificates filled out in their names. The Respondent and the fourth incorporator gave judgment notes in the amount of $2,500,[redacted] to the Corporation which were attached to the remaining stock certificates along with blank transfer powers which they also executed; and the certificates, notes, and transfer powers were held in the treasury of the corporation. Some time thereafter, the one Petitioner who had executed a note, paid the note, and received a stock certificate. The Respondent Grafton never paid the note, never offered to pay the note and never received a stock certificate. In the Spring of 1947, at a time when the Corporation was on the verge of financial collapse, the three Petitioners, feeling that the Respondent Grafton was not

devoting his efforts to the business, discharged him from his position as President of the Corporation and demanded payment of his note. When after a period of several weeks, the Respondent failed to pay his note, the Petitioners declared the stock forfeited. Three and a half years later, the company having attained a prosperous condition, the Respondent filed this bill demanding delivery to him of fifty shares of stock without however, offering to pay for it. The bill was filed in the District Court for the Eastern District of Pennsylvania. The basis for Federal jurisdiction was diversity of citizenship, the Respondent being a resident of New Jersey, and the Petitioners being residents of Pennsylvania. The District Court found for the Respondent and decreed that the Corporation should "forthwith issue and deliver" fifty shares of stock to the Respondent Grafton and that the Corporation account to the Respondent for any dividends that had been declared on the stock after deducting therefrom the subscription price of the stock. The United States Court of Appeals for the Third Circuit affirmed this decision.

REASONS FOR ALLOWANCE OF THE WRIT.

Your petitioners submit that the record of this case presents a substantial Federal question of far reaching effect. The Petitioner, General Industries, Inc., is a Pennsylvania Corporation which owes its very existence to the Constitution and Statutes of the Commonwealth of Pennsylvania. This Petitioner has been ordered by the Federal Court to "forthwith issue and deliver" stock in direct violation of the clear and unequivocal provisions of this Constitution and these Statutes. It is submitted that such a decree is incompatible with the ordered functioning of our Federal System.

It is respectfully submitted that the Court of Appeals erred in its finding that "this case involves no flouting of the basic policy underlying Pennsylvania strictures against

issuance of stock without prepayment". The Court in its opinion states:

> "It was understood that Grafton should render, as he did, full time services and the sum of $2500.00, thereafter to be paid out of his share of the profits as earned, should constitute the consideration of his stock."

The Supreme Court of Pennsylvania in *Gearhart v. Standard Steel Car Company*, 223 Pa. 385, 72 Atl. 699 (1909) said:

> "It is argued by counsel for the complainant that if this corporation could have issued fully paid-up stock to this complainant for his labor, then it could enter into a contract to issue to him for his labor, capital stock of the corporation, when it should be paid for out of the earnings of the company. But that is just what the act of assembly says a corporation may not do."[1]

The extent to which the Court of Appeals has misinterpreted the Law and Policy of Pennsylvania is indicated by the following sentence in its opinion:

> "For the evidence fully warranted the conclusion that the *call* on Grafton's stock was accelerated in derogation of the terms under which the stock was *issued*." (Emphasis supplied.)

This in a state which prohibits the issuance of stock except for "money, labor done or money or property actually received", and where nothing had been received from

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1. Although this case was decided under a prior statute, the language of that statute is almost identical to that of the present one: Act of April 29, 1874 P. L. 73 "no such corporation shall issue their bonds or stock, except for money, labor done, or money or property actually received . . ."

Grafton. It is submitted that this sentence betrays error on its face.

The Respondent in this case, has never paid or even offered to pay for this stock. The only action he took was to execute a note which is forbidden by the Constitution and the Statutes. The only legal claim which he could conceivably make under Pennsylvania Law is that the stock should be issued to him for services already performed, but this is not the claim which he has made nor is it the basis on which the District Court rendered its decision. In its adjudication the Court found that stock was issued to the Respondent for *services to be performed* in direct contradiction of the Constitution and Statutes of Pennsylvania. Moreover, the record is replete with uncontradicted evidence of the Respondent's failure to devote his time and effort to the corporation's business. The District Court touched but lightly on the question of Respondent's services:

> "The defendants seek to justify their discharge of the plaintiff on the ground that his work was unsatistory. The plaintiff is not suing for breach of a contract of employment, and defendant's right to terminate his status as an employee is not involved. Whatever his shortcomings may have been, they did not amount to a complete failure to perform such as might have justified the defendants in depriving him of his interest in the business. It may be that his abilities and his devotion to his job did not come up to expectations, but the defendants took that risk when they went into business with him."

But was not this perforce the very "risk" upon which had to be conditioned any issuance of stock to the Respondent? Such a "risk" is just what the Constitution and Statutes of Pennsylvania declare that a corporation may not take in the issuance of stock. Under the Constitution and Statutes of Pennsylvania no stock could legally issue

to the Respondent until the corporation received from him services of a value equal to the price of the stock, and such stock could be of no greater value than the value to the corporation of those services.

Issuance of stock comprises more than the mere writing of a name on a stock certificate. It is the position of your petitioners that stock was never issued to the Respondent within the meaning of Pennsylvania's Constitutional and Statutory prohibitions; and that to order the Petitioner-Corporation to "forthwith issue and deliver" stock—as did the decree of the District Court, as affirmed by the Court of Appeals, in direct violation of these provisions, is beyond the power of the Federal Court.

CONCLUSION.

It is respectfully submitted that this case presents at once a substantial federal question governing the relations between the Federal Authority and the States, and a decision on an important state question in conflict with applicable state law; and that therefore it is a proper case for review by certiorari in this Court, and that the petition for writ of certiorari should be granted.

WALTER BIDDLE SAUL,
RICHARD M. SAUL,
Attorneys for Petitioners.

APPENDIX A.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11,754

WALTER M. GRAFTON

v.

HENRY A. MASTELLER, JAMES J. McGINNIS, ALBERT J. BADER, EARL D. STICKLEN, JOHN A. DRISCOLL, JAMES F. McGOWEN, THOMAS L. McNEE AND GENERAL INDUSTRIES, INC.,
Appellants.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA.

Argued February 21, 1956

Before MARIS, STALEY and HASTIE, Circuit Judges.

OPINION OF THE COURT

(Filed April 25, 1956)

HASTIE, *Circuit Judge.*

This is an equitable proceeding in which the district court has decreed that plaintiff Grafton is entitled to fifty shares of the capital stock of General Industries, Inc., a Pennsylvania business corporation. The three men, Masteller, McGinnis, and Bader, who were associated with Grafton in the initiation of this business venture and its incorporation, have been joined with the corporation itself as defendants. Diversity of citizenship is the basis of federal jurisdiction.

The course of relevant events as indicated by the evidence and found by the district court was substantially as follows. It was the business purpose of the new venture to supply other enterprises with special or supplementary engineering services, as needed from time to time. Grafton had some knowledge and experience in this field, while his associates, two lawyers and an accountant, did not. The defendant corporation was organized with the intention that Grafton and his three associates should each become owner of one-fourth of the original issue of capital stock. It was understood that Grafton should render, as he did, full time services in getting the business started, and that these services and the sum of $2500.00, thereafter to be paid out of his share of the profits as earned, should constitute the consideration of his stock.

Pursuant to this understanding the board of directors actually voted one-fourth of the capital stock, 50 shares with par value of $50.00 each, to Grafton, and caused a proper stock certificate to be executed and issued. But pursuant to the agreement of all concerned, Grafton's stock certificate and his demand note for $2500.00, together with his signed, but otherwise blank assignment of that stock were delivered to the secretary of the corporation to hold until the stipulated $2500.00 should be earned and transferred to capital. Later, the individual defendants, themselves constituting a majority of the board of directors, voted to oust Grafton from all participation in the enterprise, and to forfeit his stock for nonpayment of the agreed $2500.00, even though the enterprise had not yet yielded any profits. These circumstances led the district court to conclude that Grafton had established his claim of original and persisting ownership of the stock in question and his right to share in accrued earnings. The defendants appealed.

As to the attempted and purported forfeiture of Grafton's stock for non-payment of the $2500.00 on demand, we agree with the district court that "no more need be said

about this than that the proceeding by which the defendants deprived the plaintiff of his stock was in entire disregard of the provisions of the statutes of Pennsylvania and of their agreement with him" For the evidence fully warranted the conclusion that the call on Grafton's stock was accelerated in derogation of the terms under which the stock was issued. In addition, the purported forfeiture was accomplished in total disregard of the procedure prescribed and made mandatory in such cases by Section 605 of the Pennsylvania Business Corporation Code, 15 P.S. § 2852-605:

> "When any shareholder fails to pay any call upon his shares properly made by the directors, at the time when such payment is due, the directors may proceed to collect the amount due in the same manner as any debt due the corporation, or they may sell, at public sale, such part of the shares of the delinquent shareholder as will pay all or any part of the installments then due from him, . . . and transfer the shares so sold to the purchaser, . . . If no bidder can be had to pay the amount due on the shares, or if the amount is not collected by an action at law . . . the shares shall be forfeited to the corporation, . . ."

We come now to the appellants' principal contention. As already pointed out, stock was issued to Grafton in consideration of services and a contractual undertaking that the par value of the stock should subsequently be paid into capital out of the share of future corporate earnings allocable to that stock. It is argued that such an arrangement for deferred payment is so contrary to the law and public policy of Pennsylvania that the claimant of stock ownership thereunder should not be accorded the assistance of equity in enforcing his claim against the corporation which has attempted to repudiate it.

This argument is based on Section 7 of Article 16 of the Constitution of Pennsylvania which provides as fol-

lows: "No corporation shall issue stocks or bonds except for money, labor done, or money or property actually received; and all fictitious increase of stock or indebtedness shall be void." However, the Pennsylvania cases are agreed that this constitutional provision, standing alone, does not cause the issuance of stock without prepayment to be void. Rather, it is necessary that the legislature shall implement the constitutionally stated policy by a statute declaring the nature and extent of any infirmity which attaches to stock so issued, and what may be done about it. *Yetter v. Delaware Valley Railroad Co.*, 1903, 206 Pa. 485, 56 Atl. 57; *Grange Nat. Bank, etc. v. Collman*, 1932, 306 Pa. 201, 159 Atl. 26; *Bradford County Telephone Co. et al., v. Young, Admr. et al.*, 1938, 329 Pa. 433, 198 Atl. 96; *In re Dissolution of New Oxford Shoe Co.*, 1942, 45 Pa. D.&C. 53. But as the parties here recognize, there is now [1] no Pennsylvania statute which covers the present situation. There is nothing in the Pennsylvania statutes which prohibits Grafton from becoming a stockholder of the defendant corporation upon the issuance of stock in his name, with the certificate retained by the secretary of the corporation until payment for the stock shall be completed out of the earnings allocated to it.

Moreover, it is noteworthy that this case involves no flouting of the basic policy underlying Pennsylvania's stricture against issuance of stock without prepayment. The Supreme Court of Pennsylvania has stated that policy in these terms:

> ". . . The primary object of the constitutional provision was to prevent the jeopardizing of the corporate property and to stop frauds upon stockholders and innocent purchasers, by the issuance of securities not

1. Since the effective date of the Business Corporation Law of 1933, which repealed section 17 of the Act of April 29, 1874, P. L. 73 as amended by the Act of April 17, 1876, P. L. 30, 15 P. S. § 131, there has been no statute implementing section 7 of Article XVI of the Constitution of Pennsylvania with relation to issuance of stock without full prepayment.

> fairly representing money or property received by the corporation, and consistent with this purpose, all that is required is that transactions involving the disposition of corporate securities must be bona fide, and not a mere device to evade the law and impose a greater obligation upon the corporation than there is any occasion for it to assume, in order to obtain the consideration received therefor." *Houghten v. Restland Memorial Park,* 1942, 343 Pa. 625, 633, 23 A.2d 497, 501-2; See also *Bell v. Aubel,* 1943, 151 Pa. Super. 569, 573, 30 A.2d 617, 619.

The arrangement of having the secretary of the corporation hold Grafton's stock, blank assignment and note until the stock should be fully paid, respected the stated policy, for it served to minimize any risk of injury to outsiders through misapprehension as to the capital structure or resources of the corporation.

Moreover, the decree of the district court provides for immediate payment of the full par value of the stock to the corporation out of the portion of actual corporate earnings found to be allocable to Grafton's stock, and it is not disputed that earnings have been more than sufficient to permit such payment. Indeed, a year after the purported forfeiture of Grafton's stock the corporation reported earnings of $40,000. and declared a dividend of $10,000.

Finally, we have noted that appellants rely heavily upon *Gearhart v. Standard Steel Car Co.,* 1909, 23 Pa. 385, 72 Atl. 699, as establishing a rule of Pennsylvania law which supports their contention. But that is a case of judicial refusal to enforce a "vague, uncertain, shifting" agreement concerning a stock acquisition which never culminated in any corporate vote to issue the stock, or even in any undertaking by the prospective stockholder to make payment for the stock he desired. Such a situation is on its face much too far removed from the case at bar to afford us any useful guidance.

We are satisfied that the district court has acted in accordance with the principles of equity, and at the same time has respected the requirements of the Constitution and statutes of Pennsylvania.

The judgment will be affirmed.